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Remarks on the Economy and Bank Supervision and Regulation

by

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at

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It is a pleasure to be with you in Columbus this afternoon.[1] I always find it helpful and informative to travel outside of Washington, D.C., to learn about views on the economy, the financial system, and, more recently, regulatory reforms. This month marks five years of my service as a member of the Board of Governors of the Federal Reserve System. Over the years, I have drawn heavily upon my experience as a former state bank commissioner and a banker in my responsibilities, especially as they relate to bank supervision, payments, and consumer and community affairs. This perspective informs my views about evolving bank regulations and the real-world impact that changes can have on financial institutions, their local communities, and the broader U.S. economy.

As you know, the federal regulatory agenda has been very active lately, with a significant volume of rules, guidance, and supervisory reforms either recently published or in the pipeline. Today, I will offer my thoughts on some of these developments. As the agencies move forward with an active and potentially disruptive reform agenda, we should pause, reflect upon these changes, and ask some questions: Are these reforms efficient? In totality, do they work together to enhance the regulatory framework, resulting in a rational and efficient framework? Are the reforms within the scope of our statutory authority? And have we met the appropriate standards of due process and public engagement?

Before I dig a bit deeper into these questions and we turn to our conversation, I'd like to offer a few thoughts on the economy and monetary policy. After sharply

[1] The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee or the Board of Governors.

tightening monetary policy over the past year and a half to reduce inflation, at our November meeting, the Federal Open Market Committee (FOMC) voted to maintain the target range for the federal funds rate at 5¼ to 5½ percent and continued the run off of the Fed's securities holdings.

We have seen considerable progress on lowering inflation, but inflation remains high and recent readings have been uneven. The latest personal consumption expenditure (PCE) inflation index data showed 12-month changes in total and core inflation of 3.4 percent and 3.7 percent, roughly similar to the previous month's reading. However, some components of core services inflation have picked up, and I see a continued risk that core services inflation remains stubbornly persistent. In my view, there is also a risk that higher energy prices could reverse some of the progress made to bring overall inflation down.

The economy has remained strong as the FOMC raised the federal funds rate, and recent data indicate that economic activity has accelerated with real gross domestic product (GDP) growing at a 4.9 percent annual rate in the third quarter. Consumer spending has also accelerated, and the housing sector appears to be continuing to rebound. The latest employment report showed a labor market with healthy job gains. Over the past year, labor force participation has improved with the average pace of job gains slowing somewhat, a sign that labor market supply and demand may be coming into better balance.

However, throughout the past few years, we have seen continued data revisions, with the most recent of these revisions reflecting significant changes to employment data. Job gains in prior months were revised lower, but average hourly earnings for the past 12

months were revised higher. The frequency and extent of data revisions make the task of predicting how the economy will evolve even more challenging, and I will continue to monitor these data carefully.

While I continue to expect that we will need to increase the federal funds rate further to bring inflation down to our 2 percent target in a timely way, I supported the FOMC's decision last week to hold the target range for the federal funds rate at the current level as we continue to assess incoming information and its implications for the outlook. Currently, the federal funds rate appears to be restrictive, and financial conditions have tightened since September. Some of this tightening has occurred through longer term bond yields, which can be volatile over time as conditions change. We don't yet know the effects of tightened financial conditions on economic activity and inflation. Moreover, there is an unusually high level of uncertainty regarding the economy and my own economic outlook, especially considering recent surprises in the data, data revisions, and ongoing geopolitical risks. But I will be closely watching the incoming data as I assess the implications for the economic outlook and the appropriate setting of monetary policy.

It is important to note that monetary policy is not on a preset course. My colleagues and I will make our decisions at each meeting based on the incoming data. However, I remain willing to support raising the federal funds rate at a future meeting should the incoming data indicate that progress on inflation has stalled or is insufficient to bring inflation to 2 percent in a timely way. Returning inflation to the FOMC's goal is necessary to achieve a sustainably strong labor market and an economy that works for everyone.

I will turn now to developments in the ongoing bank regulatory framework reform agenda and share some of my observations and takeaways. While this is by no means a comprehensive list of all of the current reforms—or reforms that may still be to come—I will focus my remarks on capital requirements reform, the Community Reinvestment Act, the cap on debit interchange fees, and climate guidance.

Capital Requirements Reform

In July of this year, the agencies proposed significant reforms to capital requirements for banks with more than $100 billion in assets. Given this threshold, many banks would not be directly impacted based on their asset size, but the proposal does provide important insights about how regulators are considering reforms more broadly.

The proposal would increase total risk-weighted assets across bank holding companies subject to the rule by an estimated 20 percent. These impacts would vary based on firm-specific attributes—but not by asset size. The contemplated capital increases do not appear to be supported by facts and analysis and will likely result in significant unintended consequences.

One could reasonably ask whether there is cause for such material change. Is this proposal designed to address identified regulatory deficiencies and shortcomings?

The U.S. banking system remains strong and resilient. The system is much better capitalized than after the 2008 financial crisis, with substantially more liquidity. And U.S. banks are subject to a range of new supervisory tools that did not exist prior to 2008. The current framework represents a risk-based, tailored approach, which strives to align regulation with risk and fulfill the congressional mandate to tailor the prudential

regulatory framework.[2] The current level of capital in the U.S. banking system is a strength, not a weakness, and is complemented by liquidity regulations and other prudential requirements that have contributed to the resilience of U.S. banks.

I am skeptical of assertions that the costs of the proposal are justified by the benefits. The proposed capital increases, if implemented, would have a tangible effect on banking activities and unintended—but predictable—consequences. For example, increases of this magnitude are likely to have a detrimental impact on U.S. market liquidity and lending, and firms without sufficient scale are likely to exit certain markets. Increased capital requirements for certain types of loans may also lead to reduced credit availability or increased cost of credit, which could disproportionately harm underserved markets, businesses, and communities. Ultimately, bank customers will bear the cost of these increases.

I do want to briefly address the role of international coordination in establishing capital standards both in the United States and around the world. International bodies and agreements can help foster the creation of similar regulatory frameworks across jurisdictions. Significant banking activities occur in the international and cross-border context, and we know that financial stability risks can spread throughout global financial markets. By engaging in international coordination, U.S. regulators can promote minimum standards across jurisdictions, and these minimum standards can improve competitive equity in banking markets and make the financial system safer.

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[2] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

While the capital proposal reflects elements of the agreed upon Basel standards, it is not a mere implementation of the Basel standards. In this proposal, the calibration—with a large increase in capital requirements for U.S. firms—far exceeds the Basel standards mandate. Instead, the scale of the increase is driven by deliberate policy choices to significantly increase capital requirements for U.S. banks over $100 billion, even for those that are not internationally active. As we have seen since the proposal was published, there has been growing support for improving the proposal's quantitative, analytical foundations, including the need for and impact of capital increases of this scale.

So, what is the path forward? In response to the considerable early public feedback, the comment period has now been extended into mid-January 2024, with a parallel effort to gather more information about the potential impact. The public and stakeholder comment process will guide a discussion of the changes needed to strike the right balance between costs and benefits. Public feedback during the rulemaking process will help to ensure that a final rule would address the proposal's deficiencies.

Although I did not support the initial proposal, I will reserve judgment for my support of a draft final rule. I look forward to engaging with my colleagues to improve the initial proposal, and then consider whether a final rule sufficiently addresses my concerns.

Policymakers may disagree about the best policy choices to further supervisory goals, but we must honestly assess the costs of reform, going beyond the direct costs to banks and their customers to include the potential harm to U.S. bank competitiveness in the global economy. Of course, this cost analysis would not be complete unless it

incorporates the impact of other concurrent and complementary proposals. The analysis must include the new long-term debt proposal for all firms with more than $100 billion in assets, and the other existing rules that affect capital and firm incentives, like the stress capital buffer and the supplementary leverage ratio.

Meaningful, accurate input can only be provided if regulators are clear about the desired end state of reforms and how they would work together to complement the framework, avoiding conflicting or contradictory requirements. Approaching reform in a piecemeal manner increases the risk of arriving at a capital end state that is inefficient, redundant, and unfair to those subject to the regulation and harmful to banks, their customers, and the broader economy.

Community Reinvestment Act

Late last month, the federal bank regulators adopted a new final rule to implement the Community Reinvestment Act (CRA). The purpose of the Community Reinvestment Act is to improve access to credit in all communities where banks are located, especially low- and moderate-income (LMI) communities. The CRA was enacted in 1977 shortly after the civil rights movement and against the backdrop of other significant federal laws designed to address financial inclusion and equal access to credit. At the time Congress passed the CRA, it found that banks had a "continuing and affirmative obligation to help meet the credit needs" of their local communities.[3] Congress reinforced this obligation by instructing the federal financial supervisory agencies to encourage banks to help meet the credit needs of those same communities.[4]

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[3] 12 U.S.C. § 2901(a)(3).

[4] 12 U.S.C. § 2901(b).

As you know, my support for the important goals of the CRA did not translate into support for the final regulations, and I would like to highlight a few specific deficiencies in the final rule that led to this result. In my view, it was absolutely essential that the final rule be straightforward and clear, encouraging banks to meet the credit needs of their communities without unintentionally disincentivizing or limiting banks from supporting their communities.

While the rule includes many positive changes, those changes ultimately did not outweigh its shortcomings, including that the agencies arguably exceeded the authority granted by the CRA statute. The rule is unnecessarily complex, overly prescriptive, and directs outcomes that result in disproportionately greater costs than benefits, adding significantly greater regulatory burden for all banks, but especially for community banks. Even the foundational question—are banks doing enough to support their communities?—is left unanswered in the final rule, perhaps because there is no evidence to support the agencies' assumption that broadly speaking, banks are falling short.

Scope and Impact on Community Banks

First and foremost, the final rule applies the same regulatory expectations for small banks as it does for the largest banks. For example, a wide range of community banks—those with more than $2 billion in assets—are treated as "large banks" under the final rule, forcing these banks to comply with the same CRA evaluation standards as a bank with $2 trillion in assets. The lack of recognition that these banks are fundamentally different, with different balance sheets and business models, misses an important opportunity to appropriately tailor CRA expectations to a bank's size, risk, service area, and business model. This approach is a radical departure within the

regulatory framework where no other provision considers a bank with $2 billion in assets "large."

As a result of this decision, many community banks will be subject to new and materially enhanced requirements, including a new retail lending test, significantly expanded assessment areas, and increased data and reporting obligations. As I made clear throughout the development of the original proposal and final rule, instead of requiring these changes, community banks should have had the option, at their discretion, to opt into the new retail lending test and assessment areas or to continue with the existing framework. The significant increases in burden and cost associated with these changes are simply disproportional when applied to community banks, in a way that may constrain the resources community banks can devote to supporting their communities.

Lack of Congressional Authorization

The final rule also arguably exceeds the authority granted by Congress. While the final rule aspires to modernize the CRA to account for changes in the way banks operate—for example, aligning the rule with current practices of extending credit in communities, including through mobile and online banking—there are limits to what the banking agencies can do. Congress alone has the power to modernize the CRA statute, including reflecting the variety of financial institutions that provide credit and financial services in their communities. In my view, some of the changes being made by the agencies in this rule, including those that evaluate banks outside of their deposit-taking footprint, are likely beyond the scope of our authority under the statute.

Clarity and Transparency

If these new standards were in place today, based on data from 2018 through 2020, there would be a nearly tenfold increase in banks with a "Needs to Improve" CRA rating. In some ways, this highlights a fallacy underlying these rule changes: that the low number of banks with a "Needs to Improve" rating *itself* demonstrates that the standards of the CRA regulations have been too lax historically, ignoring the more plausible explanation that banks work hard to support their communities. It is not appropriate for the banking agencies to materially increase the requirements on banks, resulting in a downgrade of currently satisfactory performance to "Needs to Improve," without a thorough, data-supported analysis that justifies a recalibration evidenced by actual shortcomings in bank activities.

Taken as a whole—all 1,494 pages of the final rule—it will be a challenge for banks, particularly smaller banks, to understand what they must do to continue to receive satisfactory ratings under the CRA.

Unintended Consequences and Other Problematic Provisions

Perhaps most concerning about the final rule is that it may incentivize banks to reduce their support for certain communities, forcing them to pare back lending in areas where there is a need for credit accessibility. The addition of retail lending assessment areas and outside retail lending areas, coupled with a new requirement for large banks to include an entire county instead of a partial county as an assessment area, may ultimately incentivize firms to pull back their lending.

There are many other areas of concern I have with the rule—including the odd new publication of already available HMDA data, expanded reliance on summary of

deposit data, and an implementation period of two years, which is far too brief in light of the rule's extraordinary complexity. While I have confidence that banks will make the best of this new rule, and continue to support their communities, I regret that the new final rule may complicate, and in some instances frustrate, the important goals of the CRA.

Interchange Fee Cap Proposal

Also late last month, the Federal Reserve proposed amending the regulatory cap on debit card interchange fees, citing the Dodd-Frank Act requirement that the Federal Reserve establish a cap that is reasonable and proportional to the cost incurred by the issuer with respect to debit transactions. For many years, bankers have expressed significant concern about external factors, like fraud, increasing the costs of supporting bank debit card programs—concerns that could be exacerbated by a lower regulatory cap on interchange fees. While the Board's proposed rule suggests that it could result in benefits to consumers, I am concerned that the costs of this fee cap revision for consumers—through the form of increased costs for banking products and services—will be real, while the benefits to consumers—such as lower prices at merchants—may not be realized.[5]

At its heart, the proposal is unfair to many issuers and in some ways regressive in its impacts. The proposed rule acknowledges the varied size, business models, and product offerings of banks subject to the interchange fee cap and yet aims to achieve

[5] The Board memo discussing the proposed revisions to the interchange fee cap suggests that "[m]erchants, … may pass on some portion of their savings from lower interchange fees to consumers." See "Proposed Revisions to Regulation II's Interchange Fee Cap," memorandum, Board of Governors of the Federal Reserve System, Reserve Bank Operations and Payment Systems and Legal Divisions, October 18, 2023, p. 9, https://www.federalreserve.gov/aboutthefed/boardmeetings/reg-ii-memo-20231025.pdf.

"rough justice" by establishing a single cap that applies to all covered issuers. Larger issuers—those with the highest transaction volumes, greater negotiating power, and the most efficiencies that come from scale—would continue to have a significant competitive advantage under this rule. Even the lower interchange fee may allow them to continue profitably operating their debit card programs. By contrast, smaller issuers subject to the cap—those with smaller transaction volumes, less negotiating power, and fewer efficiencies in scale—would likely be at a significant competitive disadvantage.

Retail banking is an essential, core function for many smaller issuers, so this pricing dynamic may not ultimately lead them to abandon their debit card programs. But it is certainly possible that banks will be forced to either pass costs through to customers or operate their debit card programs at a loss, which many banks do today. Under the proposed rule, a staggering one-third of bank issuers would not be able to recover even the partial costs that factor into the interchange fee cap. For banks that operate debit card programs at a loss, presumably those costs will need to be recovered elsewhere, such as through higher borrowing costs for bank customers or through other fees for services provided, which are also targeted by the banking agencies for elimination. Higher borrowing costs or fees could be particularly harmful for low-income customers who may not qualify for credit card products or other alternatives.

The fees banks charge for provided services have been criticized by some regulators, but in many instances these fees—including interchange fees—support a bank's ability to offer low-cost or no-cost banking products or services to customers. If finalized as proposed, this revision may force banks to discontinue their lowest-margin products, including options designed to increase financial inclusion and access for LMI

individuals and families. I sincerely hope that this is not the case, but it is a real and important risk.

While I am concerned by both the timing and basis for this proposed downward revision to the interchange fee cap, I want to note two other elements of the proposal. First, the proposal includes a formula for periodic updates, under which the cap would *automatically* be updated based on reported data every two years. Once this type of formulaic approach is adopted, I expect it will be very difficult to overcome inertia to revisit and reopen it, even if there are compelling reasons to do so.

Second, the proposal applies only to a subset of issuers—those with more than $10 billion in assets—but I expect the fee cap will continue to affect a broader range of issuers, including community banks and small credit unions. Issuers of all sizes use the same payment rails, and smaller issuers will inevitably face some pricing pressure, at least indirectly, from the interchange fee cap. And while the interchange fees many smaller issuers have collected since the introduction of the interchange fee cap may have remained stable, it is difficult to determine how this compares to the aggregate costs of processing, fraud and fraud prevention, and the many other inputs for running a debit card program. It is not clear that interchange fees have kept up with the increasing expenses for many smaller issuers, including repeated reissuing of debit cards due to retail industry data breaches.

Ultimately, the net result of this proposal may be to simply shift costs from merchants to bank customers, and to make those costs far less transparent (for example, if those costs are recovered through higher loan interest rates). Of course, this proposal has been published for public comment, and my colleagues and I welcome public feedback

on the proposal, particularly on the impacts it may have on financial institutions, including those not directly subject to the rule. This broader context and understanding is necessary when we revise a critical piece of the U.S. payments infrastructure.

Climate Guidance

Finally, on October 24, the Federal Reserve—in conjunction with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency—published guidance directing banks' approach to climate-related financial risks. The final guidance will create confusion about supervisory expectations and will result in increased compliance cost and burden, without a commensurate improvement to the safety and soundness of financial institutions or to the financial stability of the United States. This is another regulatory action that raises questions about need and legal basis, but also about whether the focus of reforms is appropriate in the current economic and supervisory environment. This guidance represents a departure from sound banking policy and potentially a distraction from more important risk-management objectives.

As a foundational matter, it is good to recognize that institutions of all sizes have long been expected to manage the risks associated with their activities, including these climate-related financial risks. While the guidance adopts a specialized regime for climate risks, it does not explain why this unique treatment for climate risks is warranted. The guidance simply suggests that banks are "likely to be affected" by the physical and transition risks associated with climate change. Without taking stock of risk-management practices today and evaluating whether it is appropriate as it comes to climate-related financial risks—essentially without identifying a problem statement—the guidance goes

directly to solutions that are at once unclear and expensive, without clearly promoting safety and soundness or U.S. financial stability.

Under the guidance, banks must monitor and measure climate-related risks over indefinite time horizons and "develop strategies, deploy resources, and build capacity to identify, measure, monitor, and control for climate-related financial risks." The guidance includes few specifics about this data collection expectation—which surely will expand over time—nor does it clarify how banks are intended to integrate this new information into risk-management programs and policies, and even into lending decisions. Indeed, the guidance adopts an intentionally vague standard, with an expectation that data collection and the planning horizon for "scenario analysis" to probe on such risks may extend "beyond the financial institution's typical strategic planning horizon." And yet, the benefit of requiring banks to plan for events that occur far into the future seems limited, as long-dated predictions about the future are likely to be highly speculative and heavily influenced by the underlying assumptions, and therefore of limited or no utility to the bank in managing risk. This approach is a significant departure from existing supervisory standards and includes no explanation for the deviation from normal supervisory time horizons.

In addition to being unclear, the guidance will surely be expensive to implement. The costs to implement new data collections will be substantial not only to institutions attempting to comply with uncertain elements of the guidance, but also to bank customers that will be asked to provide more information when seeking credit or other banking products. One likely potential consequence could be to discourage banks from lending and providing financial services to certain industries, forcing them to seek credit outside

of the banking system from nonbank lenders. This will undoubtedly result in decreasing or eliminating access to financial services and increasing the cost of credit to these industries.

History tells us that these increased costs will ultimately be borne by consumers. The lessons learned from supervisory failures during the bank stress in the spring clearly illustrate that bank examiners and bank management should focus on core issues, like credit risk, interest rate risk, and liquidity risk. Today's guidance could ultimately distract attention and resources from these core risks.

I have every confidence that banks will work diligently to try to understand the expectations created under the agencies' climate guidance and will craft an approach that works—despite the uncertainty the guidance itself creates. However, looking to the future, I am concerned that the scope of this guidance—which is limited to banks with over $100 billion in assets—will trickle down to far smaller institutions by treating approaches adopted by large banks as "best practices" for banks of all sizes, resulting in a much higher regulatory burden for these firms.

I am also concerned that the actions taken by banks to manage climate risk could have unintended consequences for LMI communities, including increasing the cost of credit or reducing credit availability in those communities. Consumers and businesses in LMI communities often have fewer options for obtaining credit and banking services, and I am concerned that today's guidance could exacerbate this problem. Oddly, while the guidance acknowledges this concern, it does not emphasize the obligations banks have under the CRA to help meet the credit needs of the communities in which they do business, especially in LMI communities.

While climate change is an important public policy issue in the United States and globally, the Federal Reserve has limited, narrowly focused mandates and responsibilities that are established by statute. These mandates and responsibilities do not extend to climate policymaking.[6] Although the climate guidance nominally focuses on climate-related "financial risks," I am concerned that the guidance could be used by the Federal Reserve and other federal banking agencies to pursue climate policies leveraging the opacity of the supervisory process, even though such actions would clearly exceed the statutory authorities given to the Board by Congress.

Conclusion

The recent volume and materiality of new reforms implemented and under consideration by the federal banking agencies is significant, with nearly 5,000 pages of rules and proposals published since July. While the unintended consequences of these reforms may not be clear at the outset, our ability to predict these consequences is even more limited when the reforms overlap or conflict. The sheer volume of change presents significant challenges for banks, who will be required to prioritize the implementation of new and revised requirements, with the risk of being distracted from more material concerns or supervisory issues.

My voting record on these proposals is a reflection of my concern about the path of regulatory reform, particularly in the wake of the bank failures and banking system stress earlier this year, which highlighted that some reforms may be warranted, where

[6] While the climate guidance was released shortly after the U.S. Department of the Treasury's pronouncements about net-zero financing and investment, the climate guidance is silent about "net-zero" commitments. See U.S. Department of the Treasury, Principles for Net-Zero Financing & Investment (Washington: U.S. Treasury Department, September 2023), https://home.treasury.gov/system/files/136/NetZeroPrinciples.pdf.

they address specific problems or clearly identified shortcomings. Regulators, like banks, should never shy away from improving and evolving as the underlying conditions evolve. But taking our focus away from potentially more pressing matters, like interest rate and liquidity risk management, could result in supervisors and banks that are less prepared and able to deal with emerging stresses.

In my view, our regulatory agenda should focus on evolving conditions and data-driven, identified risks. At a time when confidence in public institutions is waning, the Federal Reserve should strive to demonstrate beyond doubt that it executes its duties in an independent manner, focusing on its statutory obligations. As I've discussed today, I fear that many of these actions may fall short of this objective.